

BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTRATIVE LAW

IN THE MATTER OF THE PETITION OF)
APPLIED WASTEWATER MANAGEMENT,) BPU Docket No. WR03030222
INC. FOR APPROVAL OF AN INCREASE) OAL Docket No. PUCRS 02351-03S
IN RATES FOR SERVICE)

**INITIAL BRIEF OF THE
NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE**

SEEMA M. SINGH, ESQ.
Ratepayer Advocate

Division of the Ratepayer Advocate
31 Clinton Street, 11th Floor
P. O. Box 46005
Newark, New Jersey 07101
(973) 648-2690 - Phone
(973) 624-1047 - Fax
www.rpa.state.nj.us
njratepayer@rpa.state.nj.us

On the Brief:
Robert J. Brabston, Esq., Deputy Ratepayer Advocate

TABLE OF CONTENTS

	<u>Page No.</u>
I. PROCEDURAL HISTORY	1
II. INTRODUCTION AND ARGUMENT	3
III. REVENUE REQUIREMENT ISSUES	6
IV. RATE BASE.....	7
A. Plant in Service/Depreciation Expense	7
B. Homestead Acquisition Adjustment and Amortization Expense	9
C. Depreciation Reserve	11
D. Prepayments.....	12
E. Cash Working Capital.....	12
F. Consolidated Income Taxes.....	13
V. OPERATING INCOME	17
A. General Metered Service Water Revenues.....	18
B. Labor, Power Chemical and Residual Disposal Expenses – M.O.U.....	18
C. Management Service Agreement	20
D. Miscellaneous Treatment Expenses.....	20
E. Rate Case Expenses	20
F. Telephone Expenses	21
G. Other Operation and Maintenance Expenses.....	21
H. Depreciation Expenses	22
I. Amortization Expenses	23
J. Revenue Taxes.....	24
K. Income Taxes.....	24
VI. RATE OF RETURN.....	25
VII. RATE DESIGN.....	29
VIII. CONCLUSION.....	32

APPENDIX I

APPENDIX II

I. PROCEDURAL HISTORY

On April 13, 1989, Applied Wastewater Management, Inc. (“AWWM” or “Company”) was granted an Initial Tariff by the Board of Public Utilities (“Board” or “BPU”) pursuant to *N.J.S.A. 48:2-21(a)*. Over the past 15 years, AWWM has grown to serve 11 discrete systems in New Jersey, serving approximately 2,900 wastewater and 300 water customers. The Company has also recently concluded the acquisition of the Valley Road Sewerage Company to serve customers in a portion of Tewksbury Township, New Jersey.

One of the systems AWWM provides service to customers through is the Homestead Treatment Utility (“Homestead”). The Board approved the merger of Homestead and AWWM by Order dated May 13, 1999. In that Order, the Board expressly deferred any findings on the appropriate ratemaking treatment of the costs associated with AWWM’s acquisition of the Homestead system to the next AWWM base rate case, which is the instant proceeding. Prior to that case, the last rate increase for the Homestead customers was approved by the Board on July 6, 1993.

On or about March 28, 2003, Applied filed a petition with the Board seeking approval of an increase in rates for service. The Company seeks an overall increase in annual revenues of \$987,790, or approximately 43.92%. The Company proposes to allocate the increase as follows: a 30.64% increase in rates to general metered water customers; a 30.63% increase to public and private fire protection customers; a 93.49% increase for Homestead residential wastewater customers; a 30.64% increase to Homestead commercial wastewater customers; and a 30.64% increase to the Company’s remaining wastewater customers.

This case was transmitted to the Office of Administrative Law (“OAL”) on April 22, 2003, as a contested case and assigned to the Honorable Douglas H. Hurd, Administrative Law

Judge (“ALJ”) for evidentiary hearings and Initial Decision.

In addition to the Company, the parties to this proceeding are the Staff of the Board of Public Utilities (“Staff”), the New Jersey Division of the Ratepayer Advocate (“Ratepayer Advocate”).

A prehearing conference was held on August 5, 2003. In accordance with the schedule set forth at the prehearing conference, discovery was propounded. Public hearings were held on September 29, 2003, in Budd Lake, New Jersey; and October 29, 2003, in Columbus, New Jersey.

In support of its Rate case, concurrent with its filing, the Company filed the testimonies of Alexander Maxwell, Gary S. Prettyman, and Tim Davies.

The Ratepayer Advocate filed the Direct Testimonies of Brian Kalcic, Robert J. Henkes and Howard J. Woods, Jr., P.E., on January 9, 2004.

An evidentiary hearing was held on January 13, 2004. At the close of the hearing, a briefing schedule was established with the initial brief due on March 29, 2004.

II. INTRODUCTION AND ARGUMENT

The approximately 2,900 wastewater customers of AWWM are roughly divided into two groups. The largest group is the collection of customers around the state that are served by Community Onsite Wastewater Treatment Systems. (The Company uses the acronym “COWS” to refer to these systems.) The COWS serves approximately 1,841 customers, who are billed a flat rate of \$226 per quarter, or \$904 per year. The next largest group is made up of the approximately 1,058 customers of the former Homestead Treatment Utility. These customers pay \$110.65 per quarter, or \$442.50 per year. The Company also serves a handful of customers in Country Walk and three commercial customers. The Company provides water service to approximately 300 residential customers, four large (2 inch meter) water customers; eight private fire connections, and 24 public fire connections.

The Ratepayer Advocate met with representatives of various homeowners’ associations and dozens of residents during this case, and attended the public hearing with several hundred customers. Although the public brought many issues to light during these meetings, the dominant concern that came out of every meeting and every discussion concerned the desire of the customers to be billed on a usage based, rather than a flat, rate. The Company is not in possession of any usage data upon which usage based rates could be set, and has maintained all along that it is not opposed to using usage based rates instead of flat rates.

There is a question as to the fundamental fairness of the application of flat rates to every service connection served by AWWM. While the Company has maintained that its flat rates were previously approved by the Board, that does not resolve the issue of whether or not it is fair for a resident living alone in a single unit townhome to pay the same wastewater bill as a family of five living in a multi-story single family residential home. The Ratepayer Advocate has grave

concerns about the propriety of awarding the Company any rate relief until the issue of the application of flat rates to all customers is explored more fully. As will be argued further below, the implementation of any rate increase awarded to AWWM, if any, in this case should be stayed until the Company shows the impact of a move to usage based rates. The Company should immediately commence a Phase II proceeding where the costs of a change in billing methods, the changes in AWWM procedure, and the ultimate impact on customers will be examined by the parties to this proceeding. After such a proceeding, it may become clear that all of the rates charged by this Company need to be changed, and at that time if there is to be any increase in the Company's revenues, such an increase can be incorporated into the new, usage based bills.

A threshold legal issue in this matter concerns the Board's October 10, 2000 Order I/M/O the Joint Petition of E'town Corporation and Certain Subsidiaries of E'town and Thames Water Holdings Inc. for Approval of a Change in Control of New Jersey Public Utilities Controlled and Owned by E'town Corporation, Docket No. WM99120923 (the "E'town/Thames proceeding"). That Order specifically refers to Applied Wastewater Management, along with Elizabethtown Water and Mount Holly Water Company, as the "New Jersey Operating Utilities" (or "NJOU's"). Furthermore, the Board noted that although the Homestead Treatment Utility was not part of the NJOU's when the petition in that proceeding was filed, Homestead was officially merged into AWWM before the effective date of the Board's Order in the E'town/Thames proceeding. It is the Ratepayer Advocate's position that all of the conditions imposed by the Board in the E'town/Thames proceeding apply with equal force to all of the systems then or now owned and/or operated by AWWM.

The relevant condition reads as follows:

4. (u) No NJOU shall file an application for an increase in rates prior to April 1, 2001, and no application shall request or notice for more than an 18% increase in rates.... The Board recognized that unforeseen mandatory regulatory, legislative, accounting and tax changes beyond the control of the NJOUs may take place during the time period described in this paragraph and that the NJOUs should neither materially benefit nor suffer financially in the event of such circumstances. If such unforeseen circumstances occur and result in material financial benefit or harm, rates may be adjusted pursuant to Board approval to reflect changed circumstances.

The Ratepayer Advocate contends that this condition should apply to AWWM in this proceeding. The Company has not alleged any circumstance that would permit an exception to this condition. Therefore, the Company should be foreclosed from any rate increase in excess of 18%, or \$426,183.60, as a matter of law.

III. REVENUE REQUIREMENT ISSUES

The Company proposed a Test Year and Pro Forma Year approach to setting the rates for AWWM in this case. The Ratepayer Advocate will adopt this approach for ease of comparison among the parties' various positions. The Company's proposed Test Year in this case is the twelve-month period ending June 30, 2002, including 12 months of actual data. The Company then adjusted its Test Year results for rate base, revenue, expense and tax changes projected to occur in the "Pro Forma Year" ended June 30, 2003. Specifically, the Company's proposed revenue requirement in this case is based on projected rate base balances as of June 30, 2003. To be consistent with this post-test year approach, the Company also annualized its revenues based on projected billing determinants as of June 30, 2003, reflected depreciation expenses based on the projected June 30, 2003 depreciable plant balances, and reflected adjusted annualized O&M expenses and taxes based on expense and tax projections for the Pro Forma year ending June 30, 2003. This approach is a reasonable approach, and the Ratepayer Advocate's revenue requirement witness, Robert J. Henkes, used this approach while analyzing the Company's case. The actual results for the full 12 months of the Pro Forma Year ended June 30, 2003 were available for review and analysis and were relied on by all parties in this case.

IV. RATE BASE

The Company's proposed pro forma rate base of \$9,300,152 is summarized by specific rate base components by Mr. Henkes on Schedule RJH-3 of his direct testimony, Exhibit RT-2. All of the Company's proposed pro forma rate base balances except those for prepayments and cash working capital represent fully projected balances as of June 30, 2003, the end of the Pro Forma Year in this case. The proposed rate base balance for prepayments represents the 13-month average balances for the Test Year ended June 30, 2002 and the claimed cash working capital requirement is calculated through the so-called "one-eighth formula".

Similarly, June 30, 2003 -- the end of the Company's proposed Pro Forma Year in this case -- was used as the cut-off point for the rate base balances to be used for rate making purposes in this case. However, the Ratepayer Advocate's witnesses relied on actual rate base balances as of June 30, 2003 since that information was the most up-to-date information available. However, certain of AWWM's proposed rate base components were excluded and additional rate base balances which the Company had failed to reflect were included. These recommendations are set forth in more detail below.

As shown on Schedule RJH-3 of Exhibit RT-2, the previously described recommended rate base approach has resulted in a number of rate base adjustments with the effect of reducing the Company's proposed rate base by a total amount of \$2,468,370. Each of these recommended rate base adjustments will be discussed in detail below.

A. Plant in Service/Depreciation Expense

As stated on page 6 of Mr. Prettyman's testimony, "Rate base [plant in service] is calculated at June 30, 2003, including all projects expected to be in service at that time." The

starting point of the Company's proposed pro forma test period plant in service balance was essentially AWWM's actual plant in service balance as of December 31, 2002 of approximately \$14.8 million. The Company then projected that it would have approximately \$3.4 million of plant additions from January 1, 2003 through the end of the Pro Forma Period, June 30, 2003 in order to arrive at its proposed projected plant in service balance at June 30, 2003 of \$18,223,952. All of the projects included in this projected plant balance were assumed to be transferred to the Company's Account 101 – Plant in Service balance as of June 30, 2003.

The Company's plant in service projections for 6/30/03 turned out to be inaccurate. As shown in the response to WWR-27 (Update 9/24/03), as compared to AWWM's projected plant additions from 1/1/03 – 6/30/03 of approximately \$3.4 million, in actuality there were only approximately \$1 million of plant additions for that period. Even as of 8/31/03 – a period extending two months beyond the end of the Pro Forma Period – the actual plant additions since 1/1/03 were only approximately \$1.8 million, only slightly more than half of the plant additions projected by AWWM as of 6/30/03.

The Ratepayer Advocate recommends that the actual plant in service balance recorded on AWWM's books as of June 30, 2003 be included in rate base for ratemaking purposes in this case. As shown in the response to RAR-A-1, the actual plant in service balance as of June 30, 2003 amounts to \$16,131,467. This balance includes all of the projects that have actually been transferred to Account 101 – Plant in Service and are actually in service as of the end of the Pro Forma Period, consistent with the intent expressed on page 6 of Mr. Prettyman's testimony. As shown on Schedule RJH-3, line 1, this recommendation reduces the Company's proposed rate base by \$2,092,485.

B. Homestead Acquisition Adjustment and Amortization Expense

The Company has not adequately supported its request for rate recognition of its acquisition adjustment associated with its purchase of the Homestead system. In 1999, the Company acquired Homestead at a purchase price that was \$311,857 in excess of Homestead's net book value. While the Board approved the acquisition on May 13, 1999, it also ruled on page 3 of its Order in Docket No. WM99020090:

The journal entries recording the merger of Homestead Treatment Utility, Inc. and AWWM is approved for accounting purposes only. However, the treatment and the amount of any acquisition adjustment in rate base and all aspects of the amortization thereof will be considered in the context of AWWM's next rate case proceeding.

Starting in May 1999, AWWM has been amortizing the acquisition adjustment over a 10-year amortization period, resulting in an annual amortization of \$31,186 which the Company has been booking below-the-line. In the instant rate proceeding, the Company is proposing to move this amortization expense of \$31,186 above-the-line for ratemaking purposes while including the remaining unamortized acquisition adjustment balance of \$187,115 in rate base.

The Ratepayer Advocate disagrees with the Company's approach. The Board's Order in Docket No. WM99020090 clearly states that the ratemaking treatment of this acquisition adjustment is to be determined in the instant proceeding and implies that this determination be made based on the evidence presented in this case regarding this issue. As is evident from page 21 of Mr. Prettyman's testimony, other than proposing that it be allowed a 10-year amortization and rate base inclusion of the acquisition adjustment and stating that a portion of the acquisition adjustment will never be recovered by the Company, no additional evidence in support of this proposed adjustment has been presented by AWWM. In the most recent New Jersey American

Water Company (“NJAWC”) rate case, Docket No. WR98010015, the Board established several policy guidelines regarding the rate treatment of acquisition adjustments. One of these policy guidelines concerns the requirement for independent appraisals:

...the Board NOTICES the water and wastewater industry that, in the future, the Board expects proposed acquisitions and contemplated acquisition adjustments supported by two independent appraisals, to be submitted for Board approval prior to finalization of the acquisition agreement, and that, in the absence of a timely submittal, the acquiring company proceeds at its own risk with respect to rate treatment of those acquisitions and acquisition adjustments. [BPU Order, Docket No. WR98010015, page 21].

No independent appraisals were submitted by AWWM in support of the acquisition adjustment, either in Docket No. WR99020090 or in the instant rate case. In addition, no evidence has been presented in this case regarding the specific benefits accruing to the ratepayers from the acquisition. Since the Company has not presented any independent appraisals in support of the acquisition adjustment and has not presented any evidence showing the specific benefits that are accruing to the ratepayers from the acquisition, the Ratepayer Advocate recommends that the Board withhold rate treatment for this acquisition adjustment. The Company should continue its current below-the-line treatment of this issue. As shown on Schedule RJH-3, line 2 and Schedule RJH-6, line 12, the Ratepayer Advocate’s recommendation reduces the Company’s proposed rate base by \$187,115 and proposed test year amortization expenses by \$31,186.

The Company’s shareholders should also be held solely responsible for the premium paid to acquire the Homestead system. As the Company’s witness, Timothy Davis, testified, the fact that the Homestead plant was in imminent need of major rehabilitation was apparent to anyone

with any expertise in the industry. [Tr. 86:9-20] AWWM was also very much aware that the prior owner had done very little in the way of maintenance on the Homestead plant. [Tr. 84:4-85:24] The fact that the plant needed immediate and major upgrades strongly suggests that paying any acquisition premium would be inappropriate, and the Company has provided no mitigating factors to support its request. The Company should not be permitted to realize any rate recovery of the acquisition premium it paid for Homestead.

The Board established additional policy guidelines in NJAWC's Docket WR98010015 concerning the amortization period to be used for acquisition adjustments:

To further minimize the effect on rates, the Board ORDERS the use of a 40 year amortization period for each acquisition adjustment...

To the extent the Board were to allow rate treatment for this Homestead acquisition adjustment, the amortization period should change from 10 years to 40 years on a going forward basis and the annual amortization expense to be reflected in this case should be changed so as to be consistent with the Board's stated policy on these amortization periods.

C. Depreciation Reserve

The Ratepayer Advocate disagrees with the Company's convoluted methodology for projecting its proposed pro forma depreciation reserve balance, as outlined on filing Exhibit P-2, Schedule 25, page 3. Specifically, the Company started out with the actual reserve balance at 12/31/2001. It then added 18-months worth of annualized depreciation expenses based on the depreciable plant in service balance at 12/31/2001. Next, it added one-half of the difference between (1) its proposed pro forma annualized depreciation expense based on the projected

depreciable plant in service balance as of 6/30/03 and (2) the annualized depreciation expenses based on the depreciable plant in service balance at 12/31/2001. The Ratepayer Advocate recommends a much more straight-forward method to determine the appropriate pro forma annualized depreciation reserve balance as of June 30, 2003, a method that has been accepted by the Board in prior New Jersey rate proceedings and that has been used on a consistent basis for rate making purposes by the Delaware Public Service Commission. This method is shown on Schedule RJH-5. As the starting point it takes the actual depreciation reserve balance as of June 30, 2002, the beginning of the Pro Forma Year. To this actual starting point balance is then added the annualized depreciation expenses recommended for rate making purposes in this case. As shown on line 3 of Schedule RJH-5, this results in a recommended pro forma depreciation reserve balance of \$1,356,423. As shown on Schedule RJH-3, line 3, this recommended reserve balance is \$10,275 higher than the Company's proposed pro forma reserve balance of \$1,346,148.

D. Prepayments

The Company's proposed prepayment balance represents the 13-month average balance for the Test Year ended June 30, 2002. The Ratepayer Advocate's recommended prepayment balance represents the 13-month average balance for the Pro Forma Year ended June 30, 2003. This latter average balance is \$4,414 lower than the Company's proposed average balance.

E. Cash Working Capital

The Company has proposed a cash working capital requirement of approximately \$192,000 based on the application of the so-called "one-eighth method." Under this method, the

cash working capital is presumed to be equal to 1/8th of the Company's operation and maintenance expenses. As described on page 22 of Mr. Prettyman's testimony, the Company did not determine its cash working capital requirement through the use of a detailed lead/lag study because that "would be very expensive for a Company this size" and because "The one-eighth methodology is an accepted methodology in the absence of the Lead/Lag Study." The Ratepayer Advocate disagrees with the premise that the one-eighth method is an acceptable method of estimating actual cash working capital needs for a utility of any size on a regular, ongoing basis. The Board does sometimes allow the use of the one-eighth method for cash working capital purposes in rate cases involving very small utilities for whom a lead/lag study would be an unduly burdensome expense, the size of AWWM as a utility, its place in the NJAWC/Thames corporate family, and the magnitude of the requested rate increase at stake in this case warrant the use of a detailed lead/lag study for cash working capital purposes. The one-eighth method has many drawbacks and is an inappropriate method to approximate a utility's cash working capital, especially when it is used in a vacuum and no lead/lag study has ever been done. For example, this method is potentially very inaccurate and always results in a positive cash working capital requirement, even in cases where a utility actually has negative cash working capital requirements.

Since the Company did not present a detailed lead/lag study to support its cash working capital claim in this case, the Ratepayer Advocate recommends that AWWM's cash working capital level be set at \$0 for ratemaking purposes in this case.

F. Consolidated Income Taxes

The Board has an established policy requiring that any tax savings allocable to a utility as

a result of the filing of consolidated income tax returns be reflected as a rate base deduction in the utility's base rate filings. The BPU first established this policy in its Decision and Order (“D&O”) in the Atlantic City Electric Company rate proceeding, BPU Docket No. ER90091090J, dated September 30, 1992. In this D&O, the Board also ruled that the calculation starting point for the consolidated income tax related rate base deduction must be July 1, 1990:

...it is our judgement that the appropriate consolidated tax adjustment in this proceeding is to reflect as a rate base deduction the total of the 1991 consolidated tax savings benefits, and one-half of the tax benefits realized from AEI's 1990 consolidated tax filing...
...This finding reflects a balancing of the interests to reflect the unique period of uncertainty during the period 1987-1991. We hereby reaffirm and emphasize that the Board's policy is to reflect an equitable and appropriate sharing of consolidated tax benefits for ratepayers in future rate proceedings...

The Board reaffirmed its consolidated income tax policy in its D&O in a Jersey Central Power and Light Company (“JCP&L”) base rate proceeding, BPU Docket No. ER91121820J, dated February 25, 1993. On pages 7 and 8 of its D&O in that docket the BPU stated:

The Board believes that it is appropriate to reflect a consolidated tax savings adjustment where, as here, there has been a tax savings as a result of the filing of a consolidated tax return. Income from utility operations provide the ability to produce tax savings for the entire GPU system because utility income is offset by the annual losses of the other subsidiaries. Therefore, the ratepayers who produce the income that provides the tax benefits should share in those benefits. The Appellate Division has repeatedly affirmed the Board's policy of requiring utility rates to reflect consolidated tax savings and the IRS has acknowledged that consolidated tax adjustments can be made and there are no regulations which prohibit such an adjustment.

The issue, in this case, is not whether such an adjustment

should be made, but, rather, what methodology should be used to make such an adjustment. In this area, the courts have held that the Board has the power and discretion to choose any approach which rationally determines a subsidiary utility's effective tax rate. Toms River Water Company v. New Jersey Public Utilities Commissioners, 158 NJ Super 57 (1978). Based on our review of the record in this case, the Board REJECTS the ALJ's recommendation to accept the income tax expense adjustment proposed by Petitioner and, instead, ADOPTS the position of Staff that the rate base adjustment is a more appropriate methodology for the reflection of consolidated tax savings. The rate base approach properly compensates ratepayers for the time value of money that is essentially lent cost-free to the holding companies in the form of tax advantages used currently and is consistent with our recent Atlantic Electric decision (Docket No. ER90091090J). Moreover, in order to maintain consistency with the methodology applied in the Atlantic decision, we modify the Staff calculation and find that a rate base adjustment which reflects consolidated tax savings from 1990 forward, including one-half of the 1990 savings, is appropriate in this case.

The Company files a consolidated income tax return. Information contained in the response to RAR-A-46 in the most recent Elizabethtown Water Company rate case, Docket No. WR01040205, indicates that AWWM has participated in E'town Corporation's consolidated income tax filing since 1998.

The Company provided the information necessary to analyze AWWM's tax status in data request RAR-A-25 in this case. The Company's parent company performed these calculations and presented them in its response to a data request, RAR-EWC-A-15, made by the Ratepayer Advocate in the recently concluded Elizabethtown Water Company base rate proceeding, Docket No. WR03070510. As shown in this response, the cumulative income tax benefits allocated to AWWM from 1998¹ through 2002 amount to a negative consolidated income tax benefit of

¹ 1998 is the first year that AWWM participated in the consolidated tax filing of E'town Corporation.

\$18,000.

As shown on Schedule RJH-3, line 11, the Ratepayer Advocate recommends that the Company's rate base in this case be increased by the cumulative negative consolidated income tax benefit amount of \$18,000. The calculation method for this cumulative consolidated income tax benefit amount and the recommended ratemaking treatment are consistent with previously established Board policy.

V. OPERATING INCOME

The Ratepayer Advocate recommends a number of adjustments to the Company's proposed pro forma operating income. The Company's proposed pro forma operating income of \$127,407 is summarized by specific operating income components on Schedule RJH-6 of Exhibit RT-2, and the following narrative provides an overview of the Company's approach. In general the Company's proposed pro forma operating revenues have been annualized and normalized based on projected number of customers, hydrants, inch-feet, and sprinklers as of June 30, 2003 in order to match the revenues with the projected rate base balances as of that same date. The Company's proposed depreciation expenses were determined by applying its existing depreciation rates to its projected depreciable plant level (net of plant funded by CIAC and Customer Advances) as of June 30, 2003. The proposed pro forma O&M expenses were determined by taking the actual Test Year O&M expenses as the starting point and then adjusting these Test Year expense levels for changes during the Pro Forma Year that were deemed to be known and measurable by AWWM. Generally, the same approach was used by the Company to determine its pro forma revenue taxes and other taxes. The Company's proposed income taxes were determined by taking the proposed net operating income (before income taxes) as the starting point, then deducting pro forma interest expenses through the "interest synchronization" method and applying a Federal Income Tax ("FIT") rate of 35%.

Consistent with the Ratepayer Advocate's recommendation to use the end of the Pro Forma Year, June 30, 2003, as the cut-off point for the Company's rate base, the Company's metered and fire protection revenues should be annualized and normalized based on billing determinants as of June 30, 2003. The recommended depreciation expenses are based on the application of the Company's existing composite depreciation rate to the actual depreciable plant

balances as of June 30, 2003, net of plant funded by Customer Advances and CIAC. The recommended pro forma O&M expenses were generally determined based on actual Test Year expense levels, adjusted for known and measurable changes through the end of the Pro Forma Year ended June 30, 2003. Generally, the same approach was used for the determination of revenue taxes and other taxes. The recommended pro forma income taxes were determined through the same methodology used by the Company that was described above.

As shown on Schedule RJH-6, Exhibit RT-2, the previously described recommended operating income approach has resulted in a number of expense and tax adjustments with the effect of increasing the Company's proposed pro forma operating income by a total amount of \$273,283. Each of these recommended operating income adjustments will be discussed in detail below.

A. General Metered Service Water Revenues

In the response to RAR-A-59, the Company acknowledged that it inadvertently forgot to include the annual revenues for Four Seasons Irrigation in the Pro Forma Year operating revenues. The actual Four Seasons Irrigation revenues in 2001 were \$25,800 and in 2002 were \$25,466. For pro forma purposes in this case, it is appropriate to use the annual Four Seasons Irrigation revenues of \$25,466.

B. Labor, Power Chemical and Residual Disposal Expenses – M.O.U.

As a result of updated information provided by the Company, and a review of the methodologies employed by the Ratepayer Advocate's expert witnesses and the Company's witnesses, there is no longer a dispute as to the appropriate expense amounts associated with

these expense categories. The cumulative impact of these adjustments is summarized on the attached Appendix II.

Despite the mutual understanding reached by the parties regarding the appropriate expense levels for each of these items, the Ratepayer Advocate has concerns regarding the Company's rapid growth in labor expenses. The approach taken by the Company is described in the testimony of Mr. Prettyman, and Mr. Davies. This approach is not supported by the facts in this case. Both the testimony of Mr. Davies² and the response to RAR-A-34B confirm that AWWM's labor charges are a direct function of the actual hours worked by the AWM Operations Department. AWM's labor performed on behalf of AWWM is not allocated to AWWM on the basis of the number of customers that are being served by AWWM. Furthermore, the response to RAR-A-34 shows that even though AWWM's customers increased substantially from 2,364 in 2002 to 2,719 in the 12-month period ended 6/30/03, AWWM's labor charges *decreased* from \$496,220 to \$495,960.

As confirmed in the response to WWR-9, there is no overall management service agreement between AWWM and Applied Water Management Inc., an unregulated affiliate that provides management services, nor is there a management service agreement between AWWM and Elizabethtown Water. Also in the response to WWR-9, the Company states that ... "it will file an agreement after it is determined where in the American System it will be organized formally and from whom it will receive charges." The Company should not be permitted to seek any future rate relief until it provides regulators and ratepayers with the assurances of labor and management expense certainty afforded by a Board approved management service contract.

² Davies testimony page 3, lines 1-4.

C. Management Service Agreement

The Company agreed that it needs to file a Management Service Agreement with the Board. While the Ratepayer Advocate recognizes certain corporate governance concerns exist, such as the place AWWM will occupy in the corporate family, these concerns do not relieve the Company of its obligation to provide its customers and the regulators with the necessary documentation regarding its management costs. The Ratepayer Advocate urges that Your Honor and the Board condition any rate increase, if any, awarded in this proceeding on the Company filing a Management Service Agreement within a fixed time period.

D. Miscellaneous Treatment Expenses

In its response to RAR-A-53, the Company agreed that an annualized miscellaneous treatment expense level of approximately \$34,000 would be more appropriate to reflect for ratemaking purposes in this case than the annual expense level of \$50,981 included in the Company's proposed filing results. Thus, the Ratepayer Advocate recommends reducing the Company's proposed expense level by \$16,981.

E. Rate Case Expenses

As shown in the first column of Schedule RJH-8 of Exhibit RT-2, the Company has proposed total rate case expenses of \$15,000 for the current case, to be amortized over a proposed 3-year amortization period for an annual current rate case expense amortization amount of \$5,000. The \$15,000 is for miscellaneous rate case expenses only since all other rate case expenses for this case are being incurred by Elizabethtown Water Company personnel (primarily Mr. Prettyman) for which the charges are being allocated to AWWM through the "Cost

Allocations from Affiliates” expenses shown on Exhibit P-2, Schedule 12 of the filing.

The issue is not with the Company’s claimed total rate case expense level of \$15,000. Rather, the Ratepayer Advocate recommends that these expenses be shared between ratepayers and shareholders on a 50/50 basis in accordance with long-standing and well-established Board policy. See JCP&L, BPU Docket No. ER91121820J. In addition, given that the last rate case for AWWM was back in 1989 and for Homestead in 1993, the Ratepayer Advocate recommends the use of an amortization period longer than the 3-year period proposed by the Company. Instead, the Ratepayer Advocate recommends the use of a 5-year amortization period. As shown on Schedule RJH-8 of Exhibit RT-2, the recommended annual rate case expense level to be recognized for ratemaking purposes in this case amounts to \$1,500 and this reduces the Company’s proposed Pro Forma Year operating expenses by \$3,500.

F. Telephone Expenses

The Ratepayer Advocate’s telephone expense adjustments are outlined on Schedule RJH-9 of Exhibit RT-2. As shown on filing Exhibit P-2, Schedule 15, the Company’s proposed telephone expenses include estimated incremental SCADA related telephone expenses of \$42,000. As confirmed by the Company in its responses to RAR-E-22 and RAR-A-35C, the correct SCADA related incremental telephone expense should be \$4,800. Accordingly, the Ratepayer Advocate recommends reducing the Company’s pro forma telephone expenses by \$37,200.

G. Other Operation and Maintenance Expenses

The Ratepayer Advocate’s recommended adjustments to the Company’s proposed Other

O&M expenses are outlined on schedule RJH-10 of Exhibit RT-2. The Company's proposed pro forma level of Other O&M expenses of \$118,717 is based on the actual Other O&M expenses for the test year, increased by an estimated 3% inflation factor. In this case, the Company has made many pro forma O&M expense adjustments which it believed were known and measurable or which could be approximated with reasonable accuracy. To support these specific pro forma O&M expense increases, the Company supplied workpapers showing all calculations and underlying assumptions. However, to add an estimated general inflation factor to the remaining O&M expenses without any detailed support for the reasonableness or accuracy of the resulting costs increases is inappropriate and contrary to established BPU policy. The Ratepayer Advocate rejects that approach, and recommends the removal of the Company's proposed inflation cost increase of \$3,458. In addition, the response to RAR-A-44 indicates that the Company's proposed pro forma Other O&M expenses of \$118,717 includes \$100 for donations which should also be removed for ratemaking purposes.

In sum, the Ratepayer Advocate recommends the Company's proposed Other O&M expenses be reduced by \$3,558 to reflect these two adjustments. As shown on Schedule RJH-10 of Exhibit RT-2, this results in a recommended Other O&M expense level of \$115,159.

H. Depreciation Expenses

The Ratepayer Advocate's derivation of the annualized depreciation expense is shown on Schedule RJH-11 of Exhibit RT-2. The composite depreciation rate proposed by the Company in this case is 2.69%, as shown on filing Exhibit P-2, Schedule 19. If this same composite depreciation rate is applied to the recommended actual depreciable plant in service balance as of June 30, 2003, this results in annualized depreciation expenses of \$431,197. This depreciation

expense should then be reduced by the depreciation associated with plant funded by Customer Advances and CIAC. The resulting net annualized depreciation expense amounts to the Ratepayer Advocate's recommended expense level of \$218,130.

There are two reasons why the Ratepayer Advocate's recommended annualized depreciation expense is lower than the Company's proposed amount. First, the recommended actual depreciable plant in service balance as of June 30, 2003 is approximately \$2.1 million lower than the projected depreciable plant in service balance as of June 30, 2003 that was proposed by the Company. Second, the Company only removed the depreciation related to plant funded by CIAC. In its response to RAR-A-48, the Company conceded that this was an error in that it should have removed the depreciation related to plant funded by both CIAC and Customer Advances. Since the Ratepayer Advocate's recommendation correctly removes the depreciation related to both CIAC and Customer Advances, this is the second reason for the difference between the Company's proposed and the Ratepayer Advocate's recommended depreciation expenses.

I. Amortization Expenses

As shown on Schedule RJH-6, line 12 of Exhibit RT-2, the Ratepayer Advocate recommends removing the Company's proposed amortization expenses for ratemaking purposes. The amortization expense of \$31,186 represents the 10-year amortization of the Homestead Acquisition Adjustment that was discussed in the "Acquisition Adjustment" section of this testimony. For the reasons described there, the Ratepayer Advocate has removed these amortization expenses for ratemaking purposes in this case.

J. Revenue Taxes

The Ratepayer Advocate's recommended revenue tax adjustment is shown on Schedule RJH-6, Line 13 of Exhibit RT-2. The recommended revenue tax adjustment is a direct result of the recommended revenue adjustment on Schedule RJH-6, line 8. The revenue tax adjustment is calculated by applying the Gross Receipts and Franchise Tax rate of 12.61% to the revenue adjustment on line 8.

K. Income Taxes

The Ratepayer Advocate's recommended pro forma income tax amount is shown on Schedule RJH-12, of Exhibit RT-2. There, Mr. Henkes used the exact same methodology and calculation components as those used by the Company to derive the recommended pro forma income taxes. Therefore, there is no income tax issue per se. The only reason why the Ratepayer Advocate's recommended pro forma income taxes are different from the Company's proposed pro forma income taxes is because of the Ratepayer Advocate's other recommended adjustments in the areas of operating revenues, operating expenses and pro forma interest.

VI. RATE OF RETURN

The appropriate overall rate of return for the Company is 5.26%. This return incorporates a recommended return on equity of 9.75%, and reflects the Company's most recently available actual capital structure and the available actual average cost of debt as of the beginning of evidentiary hearings.

As shown on Schedule RJH-2, the Company is proposing an overall rate of return of 7.39%, based on a capital structure containing 55% short term debt and 45% common equity, an assumed short term debt rate of 4.43% and a requested return on equity rate of 11.00%. (Exh. RT-2)

As shown on Exhibit P-2, Schedule 26, the Company started out with the actual capital structure as of 6/30/02, containing approximately 87% short term debt and 13% common equity. The short term debt consists of Notes Payable from AWWM to E'town Corporation. The Company then adjusted this actual capital structure to 55% short term debt and 45% common equity. Mr. Prettyman explains on page 22 of his direct testimony that this pro forma capital structure "is also consistent with the last Elizabethtown Water Company rate case, which reflected a 44.84% equity ratio" and that "By the end of the conclusion of the test year, the Company's capital structure will be more in line with the ratios reflected in this case." In response to discovery, Mr. Prettyman clarified this latter statement by explaining that an equity infusion from E'town Corporation to AWWM would be made in August 2003 and that this equity addition will move AWWM's actual debt/equity ratio closer to a ratio of 55/45. On August 20, 2003, an equity infusion of \$2,820,000 from E'town Corporation was credited as Additional Paid-In Capital to AWWM's common equity balance. However, this equity infusion

did not result in AWWM achieving the capital structure sought by the Company. As shown in the response to RAR-A-46, AWWM's actual capital structure as of 9/30/03 -- reflecting the equity infusion of approximately \$2.8 million -- contains approximately 62% short term debt and 38% common equity.

The Ratepayer Advocate recommends the use of a capital structure of 62% short term debt and 38% common equity. This represents AWWM's most recent available actual capital structure that includes the impact of the recent equity infusion from E'town Corporation. It represents a significant improvement over the actual debt/equity ratio of 87/13 at the beginning of the test year and, in my opinion, is the most reasonable and appropriate structure to be used for ratemaking purposes in this case. It is not appropriate to use the Company's proposed pro forma debt/equity ratio of 55/45 just because this ratio is similar to what was used in the last Elizabethtown Water Company rate case.

The cost of short term debt used by the Company is overstated. The company explained its calculation on page 23 of Mr. Prettyman's testimony that the Company's proposed debt cost rate of 4.43% "reflects a twenty-year average of variable rate bonds and [is] consistent with the rates used for new debt in the last Elizabethtown Water Company rate case." It should be noted that in response to RAR-A-10, the Company confirms that, based upon current information, its proposed debt rate of 4.43% should be revised to 4.14%. However, the response to RAR-A-7 provides a history of the actual monthly interest rates paid by AWWM on its short term debt from January 2000 through May 2003.³ As indicated in this response, the average debt cost rate for the most recent 12-month period ended May 2003 is approximately 2.49%.

³ May 2003 is the latest month for which these short term debt interest rates were provided in the response to RAR-A-7.

Based on the previously discussed information, the Ratepayer Advocate recommends the use of a debt cost rate of 2.50% in this case. This represents the actual average cost rate that AWWM has been paying in the most recent 12 months and is the most representative cost rate that AWWM can be expected to pay on its short term debt during the rate effective period. There is no valid reason why Your Honor or the Board should assign Mr. Prettyman's proposed pro forma variable bond rate of 4.43% to a short term debt balance having an actual average cost rate of approximately 2.50%.

Finally, with regard to the short term debt issue, the parent company should make stable, long term financing available to its subsidiary and use the parent's access to capital markets to ensure that the ratepayers of AWWM are not paying for debt as if they were a small, stand-alone company.

The Company's requested return on equity is not based on any credible support. As discussed on page 23 of his testimony, Mr. Prettyman did not conduct a return on equity study in arriving at his proposed equity return rate of 11.00%. The Company's requested return on equity rate is based entirely on Mr. Prettyman's claim that "[t]his rate is comparable to that requested in recent water cases." While Mr. Prettyman has based his proposed equity rate on the rate that has been *requested* by water utilities in recent rate cases, the Ratepayer Advocate's witness, Mr. Henkes, based his recommended equity return rate on equity returns that have actually been *authorized* for ratemaking purposes in recent utility rate cases in New Jersey, including AWWM's sister company Elizabethtown Water Company, Consumers New Jersey Water Company, Public Service Electric and Gas Company, Rockland Electric Company, Atlantic City Electric, Jersey Central Power & Light Company and Elizabethtown Gas Company. The return on equity rates authorized in these recent New Jersey rate cases ranged from 9.50% to 10.00%.

Based on the return on equity range authorized by the Board in the previously listed recent New Jersey rate cases, the Ratepayer Advocate recommends the use of the midpoint of this range, or 9.75%, as the appropriate return on equity for AWWM in this proceeding.

The Ratepayer Advocate recommends an overall rate of return of 5.26%. The full calculation of this return rate is set forth on Schedule RJH-2 of Exhibit PT-2, based on the previously discussed findings and recommendations regarding the Company's appropriate capital structure, debt cost rate and return on equity requirement.

VII. RATE DESIGN

The Ratepayer Advocate recommends that no rate increase, if any is warranted, be implemented until the Company completes a Phase II proceeding on the costs and feasibility of moving to usage based rates. The Company has two large groups of customers that pay vastly different rates. Within each group, there are different demographics and usage patterns, and the overwhelming sentiment from the customers of AWWM is that there exists a great disparity from community to community between the actual customer wastewater flows and what the customers pay. While AWWM is a small, stand-alone company that has put forth a good-faith petition for rate relief, the fact remains that AWWM is part of the largest family of water companies in the United States and one of the largest in the world for that matter. The resources exist to give the Company the opportunity to study its rate design and billing and come up with a plan to make its bills fair to each and every customer it serves. The time to do that is now, not in the next rate case, because this is the first rate case for AWWM since it was formed in 1989, and their customers should not have to wait 15 years for another chance to change the way they are billed.

In the alternative, if any rate increase is awarded by Your Honor or the Board in this proceeding, the rate increase should be sharply limited, targeted, and incremental. As previously described, AWWM is constrained by prior Board Order from any rate increase in excess of 18%. The Ratepayer Advocate's direct case advocated for an overall rate decrease of \$73,536. In the event that Your Honor and the Board find that a rate increase is warranted, and the increase should not be stayed pending a usage based rate study, the Ratepayer Advocate recommends that the rate change be implemented under the following conditions:

1. No customer receives a rate increase greater than 18%;
2. No customer currently paying \$904 per year receive any increase, due to the disparity in rates currently charged; and
3. Any increase to any customer in excess of 10% to be phased-in over a minimum of two steps to avoid “rate shock.”

Under the above conditions, the maximum rate increase the Company should be permitted is \$105,292.26 (Company pro forma revenue of \$2,249,221 less \$1,664,264 COWS pro forma revenue leaves \$584,957 in pro forma revenues from all other customers times 18%).

Furthermore, this maximum rate increase would have to be broken up into two steps, the first being an overall increase of \$58,495.70 and the second an overall increase of \$46,796.56.

VIII. CONCLUSION

For all of the reasons set forth above, there should be no rate increase until the Company submits a detailed cost and feasibility study regarding alternative rate designs, including usage based rates, and that the maximum increase allowed to the Company should be set at \$105,292.26, phased-in over two steps and applied as described above.

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By: _____
Robert J. Brabston, Esq.
Deputy Ratepayer Advocate

Dated: April 5, 2004